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1999

When You Wish Upon a Star: Explaining the Cautious Growth of Royalty-Backed Securitization

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Recommended Citation

Lisa Fairfax, When You Wish Upon a Star: Explaining the Cautious Growth of Royalty-Backed Securitization, 1999 COLUM. BUS. L. REV. 441 (1999).

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In February of 1997, rock singer David Bowie introduced a new form of "securitization" when he converted his future royalties to be received from certain record sales into securities and sold those securities in a private offering for \$55 million.² While the securitization of David Bowie's music royalties represented the first such transaction in the entertainment industry, it was only the latest form of assets being used in the field of securitization. Indeed, since its advent in the early 1970s,³ the practice of securitizing mortgages and other assets has been one of the fastest growing financing techniques.⁴ Moreover, the Securities and Exchange Commission (the "SEC") has noted that asset securitization is becoming one of the dominant methods of producing capital in the United States.⁵ In fact, the SEC

² The term "security" will be used in this Article as the term is defined in section 2 of the Securities Act of 1933, as amended (the "Securities Act"). See 15 U.S.C. § 77b. Courts and the SEC have found that some, but not all, forms of securitized assets and mortgages fall within the definition of security under the Securities Act. See 2 TAMAR FRANKEL, *SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSET POOLS, AND ASSET-BACKED SECURITIES* § 12.2, at 4-9 (1991 & Supp. 1999); Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues, and New Frontiers*, 69 TEX. L. REV. 1369, 1378-79 (1991). For purposes of this Article, I will assume that mortgage-backed and asset-backed securities constitute securities within the meaning of the Securities Act.

³ See, e.g., 1 FRANKEL, *supra* note 2, § 2.4.2, at 35; Claire A. Hill, *Securitization: A Low-Cost Sweetener for Lemons*, 74 WASH. U. L.Q. 1061, 1119 (1996).

⁴ The volume of such securities has grown from roughly \$27 billion in 1988 to approximately \$380 billion in 1998. See *Speeding ABCP Train To Slow in '99*, ASSET SALES REP., Jan. 18, 1999, at 1. Even in the extremely volatile stock market of 1998, this volume was higher than investors predicted. See *ASR/MBA Survey: Bullish on 1998*, ASSET SALES REP., Mar. 9, 1998, at 1. The survey found that 42% of investors predicted that the volume of asset-backed securities would range from \$181 billion to \$200 billion, while 41% predicted that it would top \$200 billion. See *id.*

⁵ See Investment Company Act Release No. 19,105, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) 85,062, at 83,500 (Nov. 19, 1992).

has created a new office to oversee securitization transactions and plans to publish forms specifically for such asset-backed financing.⁶ Although the modern form of securitization began with "mortgage-backed securities,"⁷ securitized transactions have expanded to include a variety of different assets. Mr. Bowie's security offering not only illustrates this expansion, but suggests that other singers and copyright holders can take advantage of securitization.⁸

Securitization of music royalties can offer a variety of financing and economic opportunities to people in the music industry.⁹ The process of securitization converts future income from assets into a high quality debt or equity security

⁶ See Steven Goldstein, *SEC Creates New Group to Handle ABS, New Products*, CORPORATE FINANCING WEEK, Dec. 15, 1997, at 1.

⁷ See generally 1 FRANKEL, *supra* note 2, § 2.4.2, at 35; Hill, *supra* note 3, at 1119-20. This Article will use the terms mortgage-backed securities and mortgage-based securities interchangeably to refer to securitized mortgages and will use the terms asset-backed securities interchangeably to refer to securitized assets. These terms will also be used to encompass both debt and equity obligations.

⁸ See, e.g., Peter Newcomb, *Bonds? James Bonds*, FORBES, Feb. 23, 1998, at 43 (noting that the securitization of royalties related to songs by David Bowie may have begun a new trend that could extend not only to other musicians, but to securitizing royalties from other copyrighted works such as books by authors like Stephen King or films by such producers as Steven Spielberg). Following the David Bowie transaction, there have been some film-related securitizations. In November of 1997, Bear, Stearns & Co., Inc. ("Bear, Stearns") completed a securitization that converted revenues related to ten films yet to be made by Dreamworks, a production company partially owned by Steven Spielberg, into securities. See *Borrowers, Is this the Biggest Show in Town?*, EUROMONEY, June 10, 1998. Also, in March of 1998, a \$350 million securitization by New Line Cinema was completed. See *id.* That same month Merrill Lynch completed a securitization involving revenues related to a library of films owned by the Italian film company Cecchi Gori for approximately \$300 million. See *id.*; Andy Serwer, *A Sequel to Bowie Bonds: Supreme Securities*, FORTUNE, June 8, 1998, at 313.

⁹ See, e.g., Paul A. Baumgarten & Michael S. Poster, *Finding Cash for Royalty Recipients: Securitization Offers an Attractive Option*, NEW YORK LAW JOURNAL, May 11, 1998, at S3 (arguing that a royalty-based securitization can be a source of opportunity and flexibility to those in the entertainment industry).

while making such a security available in the capital markets. The essential advantage of such a process is that it allows the company¹⁰ or individual issuing the security to raise money at a lower cost than conventional financing techniques. Securitization also increases the liquidity of a company while diversifying its funding options. Applying securitization to music royalties allows the entertainment industry to take advantage of these benefits.

Unfortunately, replicating Mr. Bowie's success throughout the music and entertainment world may prove more difficult than anticipated. First, the fact that well compensated entertainers may have less of a need for cash than capital-hungry companies may limit the growth of such deals. Second, investors' concerns regarding the predictability of the income stream generated from music royalties may diminish the attractiveness of royalty-based securitization. Finally, the intellectual property concerns inherent in the securitization of royalties may create hurdles for its widespread growth.¹¹

This Article explores the benefits of royalty-based securitizations and identifies the potential drawbacks of such financing, particularly drawbacks caused by copyright concerns. Part I offers a definition and brief overview of the process of securitization. Part II outlines the advantages of using securitization in corporate financings. Part III explains the process of securitization as it relates to music royalties and describes the industry-related benefits of royalty-backed securitization as well as some problems that may limit the number of entertainers who may participate in such financing. After exploring the copyright concerns associated with transactions encompassing music royalties, Part III reveals how such concerns can subject these transactions to undesirable uncertainty. Part III then briefly

¹⁰ The term "company" will be used in this Article to refer to a partnership, corporation, trust, limited liability company, joint venture, joint stock company, association, unincorporated organization or government entity.

¹¹ See, e.g., Baumgarten and Poster, *supra* note 9, at S3 (explaining the limitations that copyright law places on the securitization of music).

addresses a possible solution to some of the problems posed by royalty-backed securities. The Article concludes by arguing that, while securitization of royalty payments from music can be beneficial, there are some impediments, particularly with respect to copyright issues, that must be overcome before this form of securitization can be utilized extensively throughout the music industry.

I. AN OVERVIEW OF SECURITIZATION

A. Defining Securitization

Securitization is a process whereby a company pools the right to receive certain future payments and sells that right in the form of securities.¹² The payments are generally referred to as "receivables,"¹³ while the company that owns the receivables is referred to as the "Originator."¹⁴ The Originator pools the receivables to be used in the securitization and generally transfers them to a newly formed special purpose vehicle, or "SPV."¹⁵ The SPV, which is generally

¹² There are several different definitions of securitization, but they all capture the process of pooling assets in order to sell them as securities. See 1 FRANKEL, *supra* note 2, § 1.1, at 3 (broadly defining securitization as transforming illiquid debt into securities); JAMES A. ROSENTHAL & JUAN M. OCAMPO, *SECURITIZATION OF CREDIT: INSIDE THE NEW TECHNOLOGY OF FINANCE* 3 (1988) (defining securitization as a structured process whereby loans and other receivables are packaged, underwritten and sold in the form of securities); see also Shenker & Colletta, *supra* note 2, at 1374-75 (defining securitization as "the sale of equity or debt instruments, representing ownership interests in, or secured by, a segregated, income-producing asset or pool of assets, in a transaction structured to reduce or reallocate certain risks" to ensure marketability and liquidity).

¹³ Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J. L. BUS. & FIN. 133, 135 (1994).0

¹⁴ See, e.g., *id.*; Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 Tex. L. Rev. 595, 600 (1998); G. Larry Engel & Andrew B. Koslow, *Securitization Advice for Asset-Backed Lenders*, 708 PLI/COMM 471, 474 (1995).

¹⁵ See, e.g., Schwarcz, *supra* note 13, at 135; Shenker & Colletta, *supra* note 2, at 1378. The form of the SPV may range and can be anything from a corporation to a limited partnership. To avoid tax

restricted from engaging in any activity other than owning or trading in the securitized asset, then issues securities to investors.¹⁶ The proceeds from such an issuance are used to pay the Originator for the receivables.

The SPV can issue either an equity security, representing an ownership interest in its receivables, or a debt instrument, secured by such receivables. When an SPV issues equity securities, it serves as a "pass-through" entity pursuant to which security holders receive proportionate payments from the cash flow of the receivables.¹⁷ By contrast, when an SPV issues debt instruments, it functions as a "pay-through" vehicle. The SPV issues a debt security pursuant to which security holders receive a fixed payment based on the anticipated cash flow of the receivables and secured by such receivables.¹⁸ An SPV can function as both

consequences related to a corporation, the SPV has typically been a trust under which principal and interest are passed through to the trust while the trust itself is not taxed. However, the advent of limited liability companies may present a better option for a SPV. A limited liability company avoids the adverse tax consequences related to a corporation and the disadvantages of a trust.

¹⁶ A company may not offer or sell a security except pursuant to registration under the Securities Act, an exemption from such registration, or in a transaction not subject to such registration. Like other types of security issuances, an SPV can issue its securities in a public offering registered under the Securities Act or in a private sale pursuant to an exemption. The most typical exemptions relied upon are those relating to "qualified institutional buyers" under Rule 144A of the Securities Act or "accredited investors" under Rule 501(a) of the Securities Act. For a broader discussion of exemptions see 2 FRANKEL, *supra* note 2, §§ 12.7-12.17, at 15-37. To date, all of the securitizations based on music royalties have been issued in private placements.

In order for an SPV to issue securities in the capital markets, it is important that it be structured as "bankruptcy remote." To achieve this status, the SPV must have limited business activities to help insure that the assets of the SPV will not be subject to the bankruptcy claims of creditors. See generally Schwarcz, *supra* note 13, at 135-36.

¹⁷ See, e.g., Lupica, *supra* note 14, at 600; Shenker & Colletta, *supra* note 2, at 1378 n.38.

¹⁸ See *id.*

a pass-through and a pay-through entity, issuing both debt and equity security.

In addition to its ability to issue different forms of security, the SPV also can vary the payment terms of its securities. Indeed, a debt instrument may be issued at a fixed or floating interest rate.¹⁹ Then too, the SPV may separate the payment streams of receivables and based on this separation, issue securities with different payment terms. For example, in the case of securities backed by mortgages, one security may be payable from the principal payments of such mortgages, while another may be payable only from the interest payments. Hence, the SPV may function at several different levels or in several different manners simultaneously.

B. The Modern Development of Securitization

The modern growth of securitization began in the 1970s with the federal government's attempt to foster a secondary mortgage market.²⁰ In order to assist the housing industry and home buyers during the economic downturn of the 1970s, the United States government created the Federal Home Loan Mortgage Corporation ("Freddie Mac")²¹ and authorized Freddie Mac to purchase, pool and sell mortgages as securities to the public. Freddie Mac's activities created a market for mortgage-backed securities while increasing the funding available for housing. In addition to Freddie Mac, the government broadened the authority of

¹⁹ See Hill, *supra* note 3, at 1068.

²⁰ Securitization dates from before the 1920s, see generally Shenker & Colletta, *supra* note 2, at 1380-83, but the modern form of, and recent surge in, securitization began in the 1970s. See 1 FRANKEL, *supra* note 2, § 2.4.2, at 35. In addition to the government's activities, securitization was also triggered by a change in the role of depository institutions because of the unstable economic conditions of the 1970s. See 1 FRANKEL, *supra* note 2, § 2.8, at 60-61; Shenker & Colletta, *supra* note 2, at 1388-1396.

²¹ See Federal Home Loan Mortgage Corporation Act, Title III of the Emergency Home Finance Act of 1970, Pub. L. No. 91-351, § 303(a), 84 Stat. 450, 452 (codified as amended at 12 U.S.C. § 1452(a) (1994)).

the Federal National Mortgage Administration ("Fannie Mae") to increase Fannie Mae's activities in the secondary mortgage market.²² That same year, the Governmental National Mortgage Association ("Ginnie Mae") began to guarantee the payment of certain mortgage-backed securities.²³ The government also implicitly guaranteed the securities issued by Freddie Mac and Fannie Mae.²⁴ These governmental guarantees encouraged the purchase of mortgage-backed securities by creating a relatively low credit risk for investors. In this manner, the federal government's strategies to ensure adequate financing for housing generated an increase in securitization.

The government's activities not only increased the market in these securities, but also led to the development of new and novel approaches to securitization. Ultimately, the government introduced a system of uniform documentation of mortgages and enhanced the ability of the three agencies to sell and evaluate mortgage-backed securities.²⁵ The federal agencies also developed a variety of financial structures designed to increase the marketability of mort-

²² Although Fannie Mae was created in 1938 with the authority to purchase mortgage loans, by the 1970s, it had only developed that market to a limited extent. See generally Shenker & Colletta, *supra* note 2, at 1384.

²³ See *id.* The Clinton Administration's budget proposal for 1999 included plans to privatize Ginnie Mae. Under such plans, securities issued by Ginnie Mae will continue to carry a guarantee, but will no longer have a full faith and credit guarantee. See *Privatizing Ginnie: A Political Boondoggle*, MORTGAGE MARKETPLACE, Jan. 18, 1999, at 1. As a result, it is expected that Ginnie Mae's security prices will increase. See *id.* Some analysts also believe that the liquidity and value of securities issued by Ginnie Mae could be compromised. See *id.*

²⁴ Unlike Ginnie Mae, mortgage-backed securities of Freddie Mac and Fannie Mae are not backed by the full faith and credit of the United States government. However, it is understood that the government implicitly guarantees such securities. See, e.g., *Agencies with Implied U.S. Support*, STANDARD & POOR'S CREDIT WEEK, Feb. 25, 1991, at 39-40 (explaining that securities generated by Freddie Mac and Fannie Mae are widely perceived to carry an implicit government guarantee).

²⁵ See Shenker & Colletta, *supra* note 2, at 1385.

gage-backed securities. For example, Fannie Mae created the first "stripped mortgage security," which allows the cash flow from a security to be separated into interest-only or principal-only payments so that an investor chooses to purchase a security with a preferred payment method.²⁶ This structure and similar financial innovations created by the federal agencies serve as the "prototype for all securitizations."²⁷

The success and popularity of the government's mortgage-backed securities prompted private parties to securitize mortgages. However, privately issued mortgage-backed securities involved certain tax and securities regulations' costs not associated with government-sponsored securities.²⁸ These costs, coupled with the lack of government guarantees of such securities, undermined the private sector's ability to take advantage of mortgage-backed securities. The Secondary Mortgage Market Enhancement Act of 1984 (the "Enhancement Act")²⁹ responded in part to the concerns of private participants by preempting state blue sky laws and certain other legal investment laws. The Enhancement Act also permits more companies to invest in privately issued mortgage-backed securities. These provisions enabled private companies to participate more freely in the mortgage-backed securities market.

C. Mortgage-Backed vs. Asset-Backed Securities

Primarily because of the government's supportive activities involvement, mortgage-backed securities traditionally have dominated the securitization process.³⁰ Moreover,

²⁶ See Pittman, *Economic & Regulatory Developments Affecting Mortgage Related Securities*, 64 NOTRE DAME L. REV. 497, 511-12 (1989).

²⁷ Peter F. Culver, *The Dawning of Securitization*, PROB. & PROP., March/April 1994, at 34, 36.

²⁸ See Shenker & Colletta, *supra* note 2, at 1385.

²⁹ Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1689.

³⁰ See 1 FRANKEL, *supra* note 2, § 6.2, at 181 (explaining that the mortgage-backed securities market is one of the largest in the country);

since the inception of such securities, the market has grown steadily. The volume of mortgage-backed securities issued in the first three quarters of 1998 was \$516.7 billion and the Bond Market Association predicts that the total volume for 1998 will reach a new record, topping \$600 billion.³¹ In fact, the growth of mortgage-backed securities has "outstripped the corporate bond market."³²

Securities backed by receivables other than mortgages are referred to as asset-backed securities. Automobile loans,³³ credit card receivables³⁴ and small business loans encompass the largest forms of asset-backed securities.³⁵ Although the market for the asset-backed security is less developed than the one for its mortgage-backed counterpart,³⁶ in recent years, the asset-backed securities market has burgeoned.³⁷ The volume of asset-backed securitization transactions increased from approximately \$27 billion in 1988³⁸ to roughly \$380 billion in 1998.³⁹ The growth of such

Culver, *supra* note 27, at 36 (explaining that residential mortgage loans are the most widely securitized financial asset).

³¹ See 1998 MBS Volume Topping \$600 Billion, MORTGAGE MARKETPLACE, Jan. 4, 1999, at 1.

³² Culver, *supra* note 27, at 36.

³³ Automobile loan securitization began with a \$10 million private placement by Salomon Brothers in January 1985 followed by a \$60 million public offering in March 1985. See C. Pavel, *Securitization*, ECON. PERSP. 16, 19, 20-21 (July-Aug. 1986).

³⁴ Salomon Brothers led the securitization of credit card loans with a \$50 million private placement in 1986. See Michael S. Raab, Note, *The Transparency Theory: An Alternative to Glass-Steagall Issues*, 97 YALE L. J. 603, 612 (March 1998).

³⁵ See, e.g., Hill, *supra* note 3, at 1113-14.

³⁶ See, e.g., Lupica, *supra* note 14, at 602.

³⁷ See *id.* at 602-04.

³⁸ See Michael Quint, *Usage of Credit Securitization on Verge of Explosion*, THE JOURNAL RECORD (Okla. City), Aug. 25, 1988 (noting that from 1985 to 1988 the market for asset-backed securities, excluding mortgages, had grown to \$27.7 billion).

³⁹ Although 1998 was a turbulent year, the asset securitization market performed well overall. See Dan Castro, 1999 Outlook, ASSET SALES REP., Jan. 4, 1999, at 1. Investors predict that issuances should grow by at least 10% in 1999. See *id.* One analyst predicted that the market would end at \$450 billion in 1999, while another predicted a

securitizations has now outpaced that of mortgage-backed securities.⁴⁰

Along with this growth, companies have expanded the type of receivable subject to asset securitization by issuing securities backed by receivables related to prescriptions,⁴¹ hospital accounts,⁴² and taxicab medallions.⁴³ New entities, such as state and local governments, have also taken advantage of securitizations.⁴⁴ For example, in June of 1998, Massachusetts created a new asset-backed security when it securitized income the state expected to receive from future federal highway grants.⁴⁵ Royalty-backed securities illuminate the diversification in the type of receivables being transformed into asset-backed securities.

II. BENEFITS OF SECURITIZATION

Securitization offers several benefits for a company seeking financing. First, securitization increases the li-

relatively small increase of 17% as compared to the increase of 50-75% in former years. See *Speeding Train*, *supra* note 4, at 1.

⁴⁰ See, e.g., Hill, *supra* note 3, at 1062 n.4; Anita Raghavan, *Sales of Asset Backed Issues Boom, but Mortgages Stall*, WALL ST. J., Oct. 2, 1995, at C12.

⁴¹ See Ida Picker, *The Outer Limits (innovative asset-backed deals)*, INST'L INVESTOR, APR. 1996, at 89. The Pharmacy Fund, founded in 1993, completed its first securitized transaction in January 1996, with an \$80 million private note offering. See *id.*; see also *New Prescription for ABS Market*, TREASURY MANAGER'S REP., Mar. 1, 1996 (describing a \$500 million securitization by a pharmacy group).

⁴² See Gregory R. Salathe, Note, *Reducing Health Care Costs through Hospital Accounts Receivable Securitization*, 80 VA. L. REV. 549 (1994).

⁴³ See *Myth Becomes Reality: Taxi Cab Medallions Securitized*, ASSET SALES REP., Dec. 19, 1994, at 1.

⁴⁴ See, e.g., Lupica, *supra* note 14, at 602 n.25 (discussing securitized issuances by New York City and Jersey City, New Jersey, backed by unpaid real estate taxes).

⁴⁵ For a description of the Massachusetts highway funding see *Investors Dig New Asset Class*, ASSET SALES REP., June 15, 1998 (explaining that the state had sold \$600 million in asset backed securities to help fund its tunnel project); *Paying For A Big Dig*, ASSET SALES REP., June 1, 1998 (noting that Massachusetts was set to issue \$1.5 billion in asset-backed securities over the next three years).

quidity of a company by enabling it to access future income immediately. Second, securitization enables an Originator to produce securities with a high credit rating at a low interest rate. This credit rating reduces the Originator's cost of raising capital while making its securities more attractive to investors. Third, securitization diversifies the financing options available to companies traditionally unable to access the capital markets. In these ways, securitization provides a company with a less costly and more efficient method of raising money.

A. Increased Liquidity

Securitization increases the liquidity of a company by providing it with immediate access to cash. "By definition, the process of securitization transforms future payments into instant cash, and this transformation allows entities to recognize immediately the value of these assets for a variety of uses, including current business needs."⁴⁶ Increased liquidity enables a company to pay debts and to channel its resources toward research, investments, acquisitions and other programs by enhancing its cash flow for short and long term planning.

The accounting principles applied to securitization also increase the liquidity of a company. In a properly structured securitization transaction, the Originator completely transfers the risk of nonpayment of the securitized asset to the SPV. Pursuant to generally accepted accounting principles ("GAAP"),⁴⁷ this transfer means that the risk of non-

⁴⁶ Lupica, *supra* note 14, at 609.

⁴⁷ GAAP outlines the general rules and procedures used in accounting. Pursuant to GAAP's Statement of Financial Accounting Standards ("SFAS") No. 77, a transfer of assets will be treated as a sale pursuant to accounting principles if the transfer is made "without recourse." A transfer without recourse is one in which the Originator surrenders control of the future economic benefit of the assets. Under SFAS No. 77 a transaction will be treated as a sale if (1) the Originator surrenders economic control and the future benefit of the assets, (2) the SPV has strictly limited recourse to the Originator and (3) the recourse provisions to the Originator are subject to reasonable estimation. If these three conditions are met, the securitized transaction will be treated

payment is no longer a contingent liability on the Originator's balance sheet.⁴⁸ Moreover, this transfer eliminates the Originator's need to maintain capital reserves on its balance sheet to guard against the risk of nonpayment.⁴⁹ The Originator's ability to remove these assets and their associated risks from its balance sheet enables it to channel the money otherwise designated as capital reserves to more productive purposes.⁵⁰ By freeing capital in these ways, the accounting treatment of securitization improves a company's liquidity. Indeed, this treatment has been one of the "driving force[s] behind the explosive growth of asset securitization."⁵¹

B. Lower Costs of Capital

Another benefit of securitization is that it enables a transaction to qualify for a high credit rating with a low interest rate. A high credit rating is important because it lowers the interest rate necessary to induce investors to purchase a security.⁵² A rating agency⁵³ rates a security based on the agency's predictions about whether the security will be paid on a timely basis, with the highest rating indicating a high degree of certainty that the security will

as a sale, rather than a loan. See generally Lupica, *supra* note 14, at 615-16; Engel & Koslow, *supra* note 14, at 487-89. If the transaction is viewed as a sale, then it qualifies for off-balance sheet accounting treatment. For a broader discussion of the issues associated with ensuring that a securitized transaction will be characterized as a sale rather than a loan, see Engel & Koslow, *supra* note 14, at 479-87.

⁴⁸ See Culver, *supra* note 33, at 36.

⁴⁹ See *id.* If a securitization transaction is treated as a loan rather than a sale, banks must hold capital equal to the risk-weighted total amount of the assets transferred, while savings associations in many circumstances must hold capital equal to the full value of the transferred assets. See Engel & Koslow, *supra* note 14, at 488-89.

⁵⁰ See Culver, *supra* note 27, at 36.

⁵¹ *Id.*

⁵² See Schwarcz, *supra* note 13, at 137.

⁵³ Moody's Investors Service ("Moody's") and Standard and Poor's Corporation ("S&P") represent the most prominent rating agencies. See, e.g., Schwarcz, *supra* note 13, at 136 n.14; Hill, *supra* note 3, at 1070 n.37.

be timely and fully repaid.⁵⁴ While there are several ratings that can be assigned to a given security,⁵⁵ the most significant distinction is between a rating of "investment grade" and a rating of "below investment grade." A security rated "investment grade" can be issued at an interest rate competitive with other sources of funding.⁵⁶ In addition, "[m]any regulated entities such as insurance companies and money market mutual funds may be restricted from investing in securities rated below the higher investment grades."⁵⁷

Securitization enables a security to receive a higher credit rating for at least three reasons. *First*, because rating agencies are actively involved in the securitization process, such agencies help securitized assets obtain the highest credit rating possible.⁵⁸ Because of the complexity of securitizations, rating agencies were involved in some of the first securitization transactions. Now companies with novel qualities routinely consult such agencies in the early stages of a transaction.⁵⁹ Often an agency will issue detailed in-

⁵⁴ See, e.g., Hill, *supra* note 3, at 1071; Schwarcz, *supra* note 13, at 137 n.15; Shenker & Colletta, *supra* note 2, at 1401. For a discussion of how such agencies appraise securitized securities see Shenker & Colletta, *supra* note 2, at 1402. The credit agency's assignment of credit ratings to securitized assets represented an important break-through for proponents of securitization because it allowed investors to compare securitized securities with more typical forms of securities. See Shenker & Colletta, *supra* note 2, at 1401. Moreover, because many investors rely on such ratings to reduce information costs when making investment decisions, the assignment of ratings made such securities more attractive to investors. See Schwarcz, *supra* note 13, at 137.

⁵⁵ See, e.g., Hill, *supra* note 3, at 1070 & n.39.

⁵⁶ See Schwarcz, *supra* note 13, at 137.

⁵⁷ Hill, *supra* note 3, at 1071 (citations omitted). Rule 2a-7, promulgated under the Investment Company Act of 1940, as amended, effectively prohibits money market mutual funds from investing in lower quality securities, see *id.* at 1071 n.43, and, moreover, some statutes require that insurance companies invest in the highest grade of securities, see *id.* at 1071 n.42.

⁵⁸ One author has argued that rating agencies exert pressure on companies' lawyers to issue unfounded opinion letters. See Lupica, *supra* note 14, at 608-09.

⁵⁹ See Hill, *supra* note 3, at 1071-72.

structions regarding such transactions, ensuring that companies use credit enhancements and other techniques to buttress credit ratings.⁶⁰ Credit enhancements, like third party letters of credit, or the over-collateralization of an SPV,⁶¹ make securitized assets less volatile, thereby improving the quality of the security.⁶² An agency's active participation helps Originators implement these credit enhancements and qualify their transaction for the highest credit rating possible.

Second, securitization enables a company to transfer its valuable receivables to an SPV so that a rating agency focuses on the quality of the asset being securitized as opposed to the credit worthiness of the company itself. As one author put it, "[s]ecuritization extracts from a lower rated firm some of its receivables; it leaves behind the firm and its undesirable attributes."⁶³ Therefore, securitization enables a company with deficient credit to issue securities with a higher credit rating.⁶⁴ Companies that have declared bankruptcy benefit by using the securitization process to

⁶⁰ See *id.*

⁶¹ The Originator may over-collateralize the SPV by issuing securities at a value lower than that of the underlying receivables. This ensures that the SPV has reserves to help fund the securities if the assets' collectibility weakens. See *id.*

⁶² See Picker, *supra* note 41, at 89 (explaining that because of credit enhancements, an asset backed security tends to be less volatile than other securities with identical credit ratings).

⁶³ Hill, *supra* note 3, at 1073. As explained *supra*, Part I.A, securitization involves transferring an asset to an SPV. This transfer has positive consequences for the Originator. Indeed, the financial conditions of some companies are so poor that any security issued by them would receive a low rating.

⁶⁴ See Lupica, *supra* note 14, at 613-14. The transfer feature of securitization has enabled several Latin American companies to take advantage of the U.S. public market. Indeed, many investors would hesitate to invest in Latin American companies because of concerns based on the devaluation of Latin American currencies. However, securitization enables companies based in Latin American countries to isolate their valuable receivables and sell them as securities to the public despite the Latin American companies' deficient credit status. See Picker, *supra* note 41, at 89 (noting that "securitization is virtually the only way for Latin American companies to tap the U.S. public markets.").

establish more favorable credit history.⁶⁵ Then too, a company with no credit history can use this process to establish a favorable credit rating. By shifting the focus away from financially precarious companies, securitization enables such companies to issue securities with higher ratings.

Third, the securitization process enhances the credit rating of a security by minimizing the credit risk associated with a securitized asset. A typical financial transaction generally includes one or more credit risks — such as the potential for nonpayment, bankruptcy or unexpected liabilities⁶⁶ — which can negatively affect an agency's assessment of a security. A successful securitization minimizes at least two of these risks. Securitized transactions minimize the risk of bankruptcy because they are structured as bankruptcy remote. Such a structure decreases the likelihood that a court will consolidate the securitized assets with those of the Originator and subject such assets to the bankruptcy claims of the Originator's creditors. "The diminished possibility that . . . investors will be affected by the originator's potential for bankruptcy also improves the chance that the markets will view an originator's [asset backed securities] more favorably than its direct debt issuances."⁶⁷ In addition, securitization limits the risk of unexpected liabilities. When an Originator transfers an asset to an SPV, the credit risks are limited to those associated with the pool of securitized assets, as opposed to those associated with the company generally. Once assets are securitized, "there are no unknown or uncertain events in the future that could

⁶⁵ Securitization is not a beneficial technique for companies on the brink of bankruptcy. When a company is at the brink of bankruptcy, a securitization transaction is more risky because "the SPV has a higher than normal risk of being challenged by the originator's trustee in bankruptcy." Culver, *supra* note 27, at 37; see also Schwarcz, *supra* note 13, at 137. Thus, investors may be unwilling to purchase the securities and risk that the bankruptcy court will determine that the SPV is not bankruptcy remote or that the conveyance to the SPV was fraudulent.

⁶⁶ See Lupica, *supra* note 14, at 611.

⁶⁷ *Id.* at 614. Structuring the transfer of the assets as "true sales" minimizes bankruptcy potential. See *id.* at 639-43.

alter the quality of the . . . investors' investment, the investors are not subject to the vagaries of the originator's business behavior, and their risk exposure is limited to the obvious risk associated with the assets in the pool."⁶⁸

The higher credit rating generated by the foregoing securitization procedures "translates into a lower effective interest rate" for such transactions.⁶⁹ This lower interest rate allows companies to raise funds at a lower cost. Therefore, the company has access to more money or capital via securitization. The higher credit rating coupled with this lower interest rate makes a securitized transaction economically efficient for many companies.⁷⁰

C. Diversity in Funding Options

Securitization also diversifies an Originator's funding sources by providing it with access to the capital market. Receivables by themselves are not suitable as capital market securities because they require extensive and costly appraisals and monitoring.⁷¹ However, securitization enables a company to pool a group of receivables with similar characteristics, making appraisal easier and more efficient. Hence, securitization allows a company with valuable receivables to participate in the market by providing an alternative, and best available, method for companies to raise capital. "Capital markets are the 'deepest' and most 'liquid' of all financial markets offering the greatest number of investors and transactions and often the lowest cost source of

⁶⁸ *Id.* at 612.

⁶⁹ *Id.* at 614.

⁷⁰ Securitization entails other costs such as regulatory and legal fees. *Id.* at 616-50 (discussing the costs of securitization to unsecured creditors). However, the lower interest rate, coupled with other benefits, usually outweighs such costs. See Hill, *supra* note 3, at 1085-1104 (discussing benefits of securitization such as the reduction of information costs and increased liquidity).

⁷¹ *Id.* at 1074.

⁷² *Id.* at 1073-74.

financing."⁷² Securitization represents a unique opportunity for many companies and individuals to access this source.

Companies and investors have benefited from the diversity, liquidity and enhanced credit ratings attributable to securitizing their assets. Attempting to avail themselves of these benefits, companies and individuals have become more imaginative in the type of assets they will securitize. Also, new types of issuers such as government municipalities have begun to participate in the securitization market. Royalty-backed securities represent the latest security to enter the market. The next section explores the extent to which such securities can expect the same amount of success as other asset-backed instruments.

III. SECURITIZATION IN THE MUSIC INDUSTRY

While royalty-based securitizations can be beneficial to musicians and songwriters, such transactions face obstacles that may hinder their widespread application. When Mr. Bowie securitized his music royalties, many predicted that his offering would generate a flood of similar deals. A partner at Arthur Andersen's Global Communications and Entertainment Group predicted that securitization of royalties would be "the biggest trend in entertainment in 1998."⁷³ Despite a large degree of speculation concerning potential deals,⁷⁴ and the expectations for such financing, few musicians have successfully completed royalty-based transactions. Although securitization of royalties generated from music and other copyrighted work can be advantageous, it faces several hurdles. First, these transactions may not be appealing to wealthy entertainers who do not need the capital that securitization generates. Second, concerns regarding the reliability of some royalty streams may sharply

⁷² *Id.* at 1073-74.

⁷³ Newcomb, *supra* note 8, at 43.

⁷⁴ See, e.g., Serwer, *supra* note 8, at 313 (describing securitization relating to Motown songwriters); Irv Lichtman, *Another Act in Finance Pact: New Co. Securitizes Dusty Springfield Masters*, BILLBOARD, June 6, 1998, at 91 (describing securitization of songs by Dusty Springfield).

limit the number of entertainers who may take advantage of securitization. Third, and perhaps most significantly, questions regarding the ownership of a copyright, and the conflicting case law related to the perfection of security interests in a copyright, create difficulties for the consummation of such securitizations. These factors demonstrate some of the most important reasons for the slower than predicted growth of royalty-backed securitization.

A. Background

Securitization of music royalties began in February of 1997 with a \$55 million private placement by rock singer David Bowie.⁷⁵ Because the bonds were privately issued, there is limited public information regarding the transaction. It has been reported, however, that Mr. Bowie securitized his future royalty payments and licensing fees generated from the sale and use of more than 250 songs in his record catalogue.⁷⁶ He established a trust as an SPV to which he assigned payment of his royalties.⁷⁷ The trust then issued asset-backed bonds at an interest rate of 7.9% which have an average life of 10 years and reach maturity at 15 years, Moody's gave the bonds an A-3 rating.⁷⁸ The bonds were issued on a non-recourse basis⁷⁹ and guaranteed

⁷⁵ See, e.g., Daniel Kadlec, *The Real Price of Fame: "Celebrity Bonds" are Designed to Turn Hot Talent into a Great Investment. But Will Wall Street Bite?*, TIME, Aug. 17, 1998, at 39 (calling David Bowie's deal the first deal of its kind); Ian Springsteel, *Bowie Ch-Ch-Changes the Market*, CFO, Apr. 1997, at 20 (noting that the David Bowie deal was the first securitization of music recording and publishing rights and the first securitization of any privately held intellectual property rights); *Roll Over, Brady, Here Comes Bowie*, INST'L INVESTOR, Jan. 1997, at 11 (calling David Bowie's bond offering the worlds first securitization of intellectual property).

⁷⁶ Springsteel, *supra* note 75, at 20.

⁷⁷ See *id.*; see also *On the Frontier of Creative Finance*, FORTUNE, Apr. 28, 1997.

⁷⁸ See Springsteel, *supra* note 75, at 20.

⁷⁹ See Sidney Rutberg, *Designer Bonds Could Be Height of Fashion Finance; Calvin, Donna Could Reap Millions More Along The Way*, DAILY NEWS REC., Nov. 14, 1997, at 9.

by Mr. Bowie's record distributor EMI Music.⁸⁰ Underwritten by Fahnestock & Co. ("Fahnestock"), all of the bonds were sold to Prudential Investments.⁸¹

Mr. Bowie's deal generated excitement among corporate and entertainment personalities, prompting them to establish the mechanisms by which securitization of entertainment royalties could be generated.⁸² David Pullman, the managing director of the Fahnestock group responsible for arranging the David Bowie bonds, established the Pullman Structured Asset Sales Group (the "Pullman Group") "to chase celebrity bonds."⁸³ Also, Ethan Penner, head of Nomura Securities, set up an entertainment lending division of Nomura Securities and planned to build a portfolio of loans to be securitized as a group in the future.⁸⁴ In February of 1998, Charles Koppelman, former head of EMI Capital Music, teamed with Prudential Securities, a division of Prudential Insurance, to create CAKUniversal Credit Corporation ("CCC").⁸⁵ Prudential Securities planned to invest more than \$200 million in CCC.⁸⁶ Initially focusing on the securitization of music royalties, Koppelman intends for CCC to eventually securitize any intellectual property with a proven income stream.⁸⁷ With a similar goal, another division of Prudential Insurance established a joint venture

⁸⁰ See Springsteel, *supra* note 75, at 20; *Borrowers*, *supra* note 8, at 107.

⁸¹ See *id.* Prudential Investments is owned by Prudential Insurance Company of America.

⁸² As a result of the attention generated by the David Bowie deals, 1998 saw the first ever "Forum on Music and Motion Picture Securitization." See Serwer, *supra* note 8, at 313.

⁸³ Kadlec, *supra* note 75, at 39.

⁸⁴ See Erica Copulsky, *Can Ethan Penner Securitize Rock 'n' Roll?*, INV. DEALERS' DIG., Dec. 15, 1997, at 16; *Borrowers*, *supra* note 8, at 107.

⁸⁵ See Newcomb, *supra* note 8, at 43.

⁸⁶ See *id.*

⁸⁷ See *id.*

with RZO Co., a New York business management firm,⁸⁸ entitled Entertainment Finance International ("EFI").⁸⁹

However, most of these companies have found it difficult to achieve success similar to Mr. Bowie. As one author noted, the David Bowie deal "was supposed to ch-ch-change everything A flood of deals was anticipated. Instead, nothing."⁹⁰ Indeed, no other deals involving securitized music royalties were completed in 1997, and only a few were completed in 1998.⁹¹ The Pullman Group concluded the second royalty-backed issuance in August of 1998 with a \$30 million private offering by Motown songwriters Edward Holland, Brian Holland and Lamont Dozier, authors of songs such as "Stop! In the Name of Love."⁹² The trio securitized their future royalties generated from more than 300 songs. Unlike Mr. Bowie's deal, the Motown transaction did not include a guarantee.⁹³ The securities were structured as bonds and received a single A rating from Moody's.⁹⁴ Maturing in 15 years,⁹⁵ the bonds were sold to Fahnestock with a possibility that they would be resold to the public.⁹⁶ The Pullman Group ended 1998⁹⁷ with another

⁸⁸ RZO is the Rascof Zysblatt Organization headed by Bill Zysblatt, business manager for artists such as David Bowie and the Rolling Stones. See *Borrowers*, *supra* note 8, at 108.

⁸⁹ See Lichtman, *supra* note 74, at 91.

⁹⁰ Serwer, *supra* note 8, at 313.

⁹¹ There was a securitization of film revenues in November of 1997. See *Borrowers*, *supra* note 8.

⁹² See, e.g., Alice Rawsthorn & Jeremy Grant, *Songwriters in \$30M Bond Issue*, FINANCIAL TIMES, Aug. 4, 1998, at 26; Serwer, *supra* note 8, at 313; Ross A. Snel, *New 'Bowie' Bonds Bank on Royalties from Motown Trio*, WALL ST. J., Apr. 29, 1998, at C24.

⁹³ See Snel, *supra* note 92, at C24.

⁹⁴ See Leslie Eaton, *You Too Can be Rated AAA*, N.Y. TIMES, June 7, 1998, § 4, at 2. See, e.g., Hill, *supra* note 3, at 1070 n. 34.

⁹⁵ See Rawsthorn & Grant, *supra* note 92, at 26.

⁹⁶ See *Motown Gets It On: R&B Catalog Bonds Selling to the Tune of \$30M*, N.Y. POST, Apr. 9, 1998, at 28.

⁹⁷ See *The Real Thing*, N.Y. POST, Nov. 30, 1998; Ashford & Simpson *Securitizing*, ASSET BACKED ALERT, Nov. 30, 1998, at 2; Roy Furchgott, *Forget About the S&P 500; Consult the Hit Parade Instead*, N.Y. TIMES, Nov. 29, 1998, § 3, at 2.

securitization, for R&B musicians Ashford & Simpson. Concluded in late November, Ashford & Simpson's deal was based on royalties from such songs as "Ain't No Mountain High Enough" and "I'm Every Woman."⁹⁸ Like the prior two transactions, their offering involved the issuance of a debt security. The amount of the securitization was reportedly valued at \$11 million.⁹⁹

In May of 1999, the Pullman group completed a transaction for James Brown, the "Godfather of Soul."¹⁰⁰ Backed by royalties from over 750 of Mr. Brown's songs, the transaction was structured as a bond offering and is expected to earn Mr. Brown between \$35 and \$55 million.¹⁰¹ The deal has a ten year final maturity with a seven year average life.¹⁰² An unnamed institutional investor purchased the entire offering, which carries an 8% coupon.¹⁰³

Few companies outside of the Pullman Group have been able to complete a royalty-based securitization.¹⁰⁴ In February of 1999, however, Global Entertainment Capital LLC concluded a \$30 million securitization for the heavy metal band Iron Maiden.¹⁰⁵ This twenty year transaction was backed by royalties associated with 15 of the band's albums

⁹⁸ See *id.*

⁹⁹ See Akil Salim Roper, *Papa's Got a Brand New Bond*, PRIVATE PLACEMENT LETTER, May 10, 1999.

¹⁰⁰ See David Henry, *Brown's Brand-New Bag: \$30M Loan on Royalties*, USA TODAY, June 16, 1999, at 1B.

¹⁰¹ See Roper, *supra* note 99.

¹⁰² See *id.*

¹⁰³ See Akil Salim Roper, *Iron Maiden, Dylan on Tour in ABS Market*, PRIVATE PLACEMENT LETTER, Feb. 15, 1999.

¹⁰⁴ Although no transactions have been officially announced, Koppelman has claimed to have completed several royalty-based offerings. See *Cele-bond Financiers Battle for Lime Light*, N.Y. POST, Dec. 17, 1998. Because all royalty-based securitizations to date have been private placements, such deals could occur without public knowledge.

¹⁰⁵ See Roper, *supra* note 103.

and received a positive investment grade rating from Moody's.¹⁰⁶ Last year, EFI, Prudential Insurance and RZO's joint venture concluded a securitization based on future royalty payments from 250 songs by Dusty Springfield.¹⁰⁷ Because Springfield did not own all of the songs for which securitization was sought, her record label, Mercury Records, assigned her royalties to EFI.¹⁰⁸ Springfield's securitization did not exceed \$10 million.¹⁰⁹ Additionally, in April of 1998, Nomura finalized a \$15.4 million loan to rock singer Rod Stewart.¹¹⁰ Nomura planned to package Stewart's loan with similar ones creating a fund based on securitized music and other entertainment royalties.¹¹¹ Nomura's inability to complete more deals, however, probably prompted it to close its entertainment division.¹¹² Thus, despite early excitement and lofty predictions, only a relative few transactions actually were consummated.

In addition to these completed deals, investors and entertainers have discussed several other royalty-based transactions. In the beginning of 1998, the Pullman Group began packaging a group of loans,¹¹³ and was recently rumored to be expecting to issue a \$100 million securitization backed by the royalties of several entertainers, including Bob Dylan.¹¹⁴ In July 1999, Koppelman's CCC announced plans to complete a \$100 million securitization with royalties from different artists, but this transaction has yet to be completed.¹¹⁵ The Pullman group is also considering a secu-

¹⁰⁶ See *Business Briefs*, N.Y. POST, Feb. 10, 1999.

¹⁰⁷ See Lichtman, *supra* note 74, at 91.

¹⁰⁸ See *id.*

¹⁰⁹ See *id.*

¹¹⁰ See *Borrowers*, *supra* note 8; Copulsky, *supra* note 84.

¹¹¹ See *id.*

¹¹² See Michael A. Hiltzik, *Despite Hype, Royalty-Backed Bonds Haven't Gone Platinum*, L.A. TIMES, Jan. 8, 1999, at C1.

¹¹³ See *Firm Looks to Securitize Hit-Parade of Rockers Writers*, CORP. FIN. WK., Mar. 16, 1998, at 5. Reports initially stated that Pullman's pool of loans would feature folk singers Crosby, Stills & Nash. See *id.*

¹¹⁴ See David Feldheim, *Pullman Preps Multi-Asset Securitization*, ASSET SALES REP., June 28, 1999, at 1.

¹¹⁵ See David Feldheim, *Elton John Poised to Tap Asset-Backed Market*, ASSET SALES REP., July 5, 1999, at 1.

ritization deal with Elton John¹¹⁶ as well as a seven-figure securitization involving the song "I Love Rock and Roll."¹¹⁷ Although these deals have generated excitement in the music industry, their completion is uncertain. Indeed, one deal with pop singer Michael Jackson expected to be worth more than \$100 million¹¹⁸ has recently been shelved because of issues related to shared copyright ownership.¹¹⁹

B. Describing Royalty-Based Securitizations

Like other asset-backed securitizations, those involving royalties convert valuable assets into high quality securities. In these transactions, musicians assign their rights to receive future royalty payments to an SPV. The royalty payments are generated from fees related to a song's use on the radio, in movies, or in connection with other advertisements. The SPV packages the right to receive such royalty payments into a security that it subsequently issues. To date, all of the securities backed by royalties have been issued as bonds. Such bonds constitute debt obligations of the SPV and are repaid over a fixed number of years from the income generated by the royalty fees. The artist's copyright serves as security for the bonds in the event of their default. Once the bonds mature, the security interest in the copyright is released and the royalty payments revert back to the musician.

The bonds earn a high credit rating, and, concomitantly, pay out lower rates as a result of credit enhancements. David Bowie's bonds, for example, benefited from a guaran-

¹¹⁶ See *id.*

¹¹⁷ See *Rock & Roll? I Love It*, ASSET SALES REP., Sept. 21, 1998, at 1; Irv Lichtman, *Joan Jett Song: A Financial Rocket?*, BILLBOARD, Sept. 15, 1998.

¹¹⁸ See, e.g., Johnnie L. Roberts, *A Thriller on Wall Street: Michael Jackson Wants to be a Hit with Investors*, NEWSWEEK, Nov. 23, 1998; Linda Romine, *Royalties for Sale*, MEM. BUS. J., Oct. 2, 1998, at 25. The transaction was to be based on future royalties from Michael Jackson's songs as well as some Beatles hits he owns including "Yesterday" and "Let It Be."

¹¹⁹ See Danielle Duran, *Shared Royalties Thwart Jackson Transaction*, PRIVATE PLACEMENT LETTER, Feb. 1, 1999.

tee by Mr. Bowie's record distributor.¹²⁰ Moreover, Mr. Brown's bonds were enhanced because of over-collateralization. In fact, those familiar with the deal estimated that the value of the royalties underlying Mr. Brown's offering was between \$40 and \$50 million, at least \$10 to \$20 million more than the bond issuance.¹²¹ Each of these enhancements therefore enabled the bonds to receive a high credit rating from agencies.

Because the securitization process focuses on the quality of the asset being securitized, the key consideration for a successful royalty-based securitization is the quality of the royalty stream underlying the security. The royalty payments on which the security relies must be predictable and significant so that agencies and investors can be assured that securities backed by the payments will be repaid.¹²² This assurance enables the rating agencies to give the security a high rating. Historically predictable royalty payments are also important because they enable analysts to properly predict future income and hence properly value the bond. For these reasons, securitization of music royalties involves a careful scrutiny of the royalty payments generated by songs.

C. Assessing Some of Securitization's Benefits and Impediments

While securitization can offer benefits to the music industry, not all artists can take advantage of those benefits. Indeed, similar to other asset-based transactions, royalty-based securitization enables entertainers to raise a large sum of money quickly and more efficiently. Securitization increases the liquidity of entertainers by providing them access to immediate cash with favorable tax consequences. Such transactions also can diversify entertainers' financing options, allowing them to retain one of their most

¹²⁰ See *Borrowers*, *supra* note 8, at 107.

¹²¹ See Aleksandrs Rozers, *Godfather of Soul Brings Show to Wall Street*, CALGARY HERALD, May 16, 1999, at E3.

¹²² See Baumgarten & Poster, *supra* note 9, at S3.

valuable assets while taking advantage of the capital market.¹²³ Unfortunately, many artists may not be able to take advantage of the benefits of securitization. Apart from the copyright issues which will be discussed separately, many entertainers may not need the increased liquidity a securitization transaction can generate. Moreover, because securitizing royalty-based assets requires a reliable stream of income uncommon to all but a few top selling artists, only a limited number may be able to take advantage of these deals. In addition, because the success of these securities, like that of all songs, depends upon the popularity of the music, certain artists and even genres of music may not appeal to investors. These factors limit the number of artists who may participate in a royalty-based securitization.

1. Benefits Related to Liquidity and Diversity of Funding Sources

Securitizing music royalties improves an artist's liquidity by producing immediate cash. Instead of waiting for small sums of money over the next several years, an artist engaged in securitization will be able to convert his or her future royalty streams into a lump sum cash payment. Such liquidity thereby enables entertainers to channel their resources to other ventures. "They can start a new company, buy back copyrights they may have sold, set up a trust for their children [or] settle outstanding obligations."¹²⁴

Moreover, by giving entertainers access to the capital markets, securitization enables them to take advantage of

¹²³ The process of assigning royalty payments also creates a favorable credit rating for these transactions, making them attractive to institutional investors. For such people, securitization offers a method of establishing a security with a high credit rating. In addition, the transactions can benefit from credit enhancements, such as a guarantee, to minimize the credit risk associated with the asset and enhance the rating of the security.

¹²⁴ Baumgarten and Poster, *supra* note 9, at S3; see also Copulsky, *supra* note 84 (noting that artists can use extra funds to diversify their portfolios or reclaim their artistic work).

more lucrative financing. Often artists seeking cash will attempt to secure either a new recording or distribution contract or to borrow money against their royalty stream. Securitization can generate more income than either of these options. One attorney estimates that "an artist [that uses securitization] may expect to raise between six and nine times the yearly net on their [record] catalog."¹²⁵ Indeed, Mr. Bowie decided to use securitization after his business manager compared the funding available from a distribution deal with the money that could be raised from the securities market and found that securitization offered a more profitable source of income.¹²⁶ As David Pullman asserted, through his securitization "Bowie got well in excess of the bids received from the major record companies."¹²⁷ Then too, securitization offers a more profitable source of income than an artist would receive from a loan against her royalty stream. One attorney observed that banks will lend musicians only 70 to 80 percent of what they believe the value of their royalty stream is worth.¹²⁸ By contrast, securitization allows an artist to capitalize on the full value of her royalty income. Thus, securitization provides an entertainer with a more profitable alternative to the traditional method of raising cash.

Securitization also provides an entertainer with a tax deferral and deductions which increase the entertainer's liquidity. From a tax perspective, the money received through a securitization is viewed as a loan. Hence the entertainer does not have to pay income taxes on this

¹²⁵ Romine, *supra* note 118, at 26 (quoting Donald Smart, the senior vice president of an investment banking firm reportedly working on securitizing royalties from Bob Marley and Michael Jackson).

¹²⁶ See Dominic Bencivenga, *Bowie Bonds: Pioneer Deal Uses Copyright to Raise Capital*, NEW YORK LAW JOURNAL, May 15, 1997, at 5. Mr. Bowies manager explained that once the two were compared the decision to try out the securities market was a "no-brainer." *Id.*

¹²⁷ *Ain't Too Proud To Sell*, BLOOMBERG, Oct. 1998, at 118 (quoting an interview with David Pullman).

¹²⁸ See Baumgarten and Poster, *supra* note 9, at S3.

money.¹²⁹ In fact, an artist's tax payments do not resume until the royalty payments are earned. Moreover, assigning the royalty payments through securitization may permit the artist to deduct interest payments on the securitized loan, if the entertainer is deemed to be engaged in a trade or business and the entertainer uses the funds for a business purpose.¹³⁰ These tax advantages enhance the attractiveness of a securitization because they enable entertainers to access cash otherwise channeled toward tax payments.

By diversifying the funding opportunities available to entertainers, securitization also provides them with the ability to retain valuable copyrights and gain greater independence. Prior to securitization, one of the only ways an entertainer could take advantage of income based on future music royalties was to sell the copyright to her song. This limitation is also true for estate holders of deceased artists who are often forced to sell copyrights in order to satisfy the debts of an estate.¹³¹ But for many such estate holders and artists, "selling a copyright is like selling a birthright."¹³² More important, once a copyright is sold, an artist cannot participate in the future appreciation of a successful song. In a securitization, the artist does not sell her property rights. Rather the revenues from the rights are temporarily assigned. If the assigned revenues are converted into a bond, the copyright serves as collateral. Once the bond is repaid, the security interest in the copyright is released. The author will not only continue to retain property rights, but will also capture all benefits of his or her song's increase in value when the bond matures. Also, in the case of bonds, if the royalties generated by the copyrighted songs

¹²⁹ See, e.g., Kadlec, *supra* note 75, at 39; Baumgarten and Poster, *supra* note 9, at S3. See also 1 MERTENS, LAW OF FEDERAL INCOME TAXATION § 512 (rev. ed. 1969); Moore v. United States, 412 F.2d 974, 978 (5th Cir. 1969) (holding that bona fide loans are not included in taxable income because their temporary benefit is offset by the corresponding obligation to repay them).

¹³⁰ See Baumgarten and Poster, *supra* note 9, at S3.

¹³¹ See *id.*

¹³² *Id.*

are greater than expected, the bonds would be retired early, enabling the artist to access royalty payments sooner than expected. Therefore, securitization preserves the benefits of a valuable copyright for the entertainers. The diversity derived from securitization therefore "is a way to empower the entertainer . . . and reduce his or her dependence on record companies."¹³³ Instead of transferring rights to record companies, securitization allows entertainers to raise cash independently.

2. Industry-Related Impediments to Securitizations Backed by Royalties

Unfortunately, artists who are the best candidates for securitization may not need the additional cash that it provides. The head of the asset-backed finance group at Prudential Securities explained that royalty-based securitizations are only appropriate for entertainers who need a large sum of cash. For example, Mr. Bowie needed to raise large funds in order to both buy out his manager, who owned some of the rights to Mr. Bowie's music, and to satisfy tax concerns related to his UK residency.¹³⁴ Furthermore, music industry sources report that Michael Jackson needed a securitization because he was in a "cash crunch."¹³⁵ After a \$20 million legal settlement and relatively unsuccessful recent albums, Mr. Jackson was unable to adequately meet his personal expenses, reported to be in excess of \$1 million each month.¹³⁶ Similarly, securitization may be an appropriate financing tool for Elton John who is faced with over \$11 million in debt.¹³⁷ By contrast, other artists with historically high revenue payments may not need such a boost to their income. Addressing this concern, a managing director in Bear, Stearns's media and entertainment group explained that she "spent more time [after the David Bowie

¹³³ Romine, *supra* note 118 (quoting Donald Smart).

¹³⁴ See Borrowers, *supra* note 8, at 112.

¹³⁵ See Roberts, *supra* note 118.

¹³⁶ See *id.*

¹³⁷ See Feldheim, *supra* note 115, at 1.

deal] educating [recording artists] about why [securitization] would not make sense for them — namely, they don't need the money."¹³⁸

Even after a recording artist determines that she needs a large sum of money, a securitization is possible only if she can show that her royalty revenues have generated a reliable and significant stream of income. However, only a small percentage of artists have such a historically consistent record producing ability that will satisfy this criterion. Deals similar to David Bowie's are unlikely to become the norm because few artists are able to boast income streams as consistently as high as his.¹³⁹ Conversely, securitization cannot generate the cash flow necessary to attract investors for many artists who need the money most. Singers with only one major hit song or artists who are relatively new and hence have an uncertain future will not be able to take advantage of these transactions. Because of these considerations, "the universe of artists who could take their gig to Wall Street is limited."¹⁴⁰

Also, many artists transfer the ownership of their copyrights to record companies, making it difficult for them to take advantage of securitization transactions. In the music industry, it is common for individual entertainers to transfer ownership of their copyrights to record companies.¹⁴¹ As one author put it, "[m]ost rock and rollers sell major pieces of themselves along the way."¹⁴² Because he owned the

¹³⁸ Copulsky, *supra* note 84 (quoting Lisbeth Barron, a senior managing director of Bear, Stearns's media and entertainment group).

¹³⁹ See *Borrowers*, *supra* note 8, at 112 (Pullman also notes that transactions similar to Mr. Bowie's are applicable only to the top ten percent of the music industry); see also Copulsky, *supra* note 84.

¹⁴⁰ Copulsky, *supra* note 84.

¹⁴¹ See generally, Theresa E. Van Beveren, Comment, *The Demise of the Long-Term Personal Services Contract in the Music Industry: Artistic Freedom Against Company Profit*, 3 UCLA ENT. L. REV. 377, 384-85 (1996) (explaining that the first contracts of most artists usually transfer ownership of their copyrights to the record company).

¹⁴² Serwer, *supra* note 8, at 313. See also *Ain't Too Proud*, *supra* note 127, at 119 (quoting Pullman as noting that "over time [artists] have been forced to sell" their copyright).

copyrights to every song in his catalog, David Bowie's deal was unique and will not be easy to replicate.¹⁴³

The fact that royalty streams may be vulnerable to listeners' tastes also creates uncertainties that may prevent certain artist from taking advantage of securitization. Like the music from which they originate, royalty-based securities depend on the continued popularity of an artist and her music. Investors may be hesitant to structure deals because of this heavy reliance on musical preferences which are subject to change. Then, too, investors may deem certain genres of music unsuitable for securitization because they represent a "passing fad," appealing only to a particular audience. Some insiders believed that "potential investors might balk" at the issuance related to heavy metal artists Iron Maiden because the popularity of that style of music has decreased.¹⁴⁴ Similarly, bankers were reportedly hesitant to embrace a deal involving rap artists Tupac Shakur, Snoop Doggy Dogg and Dr. Dre because "the genre has enraged middle America."¹⁴⁵ Although most deny it, some industry insiders maintain that investors tend to devalue hip-hop music because of the racial and cultural characteristics associated with it.¹⁴⁶ Despite the success of rap music, skeptics continue to question whether the assets related to such music "will ever command rock's mammoth value."¹⁴⁷ The belief that hip-hop music's future value will not be significant could prevent investors from embracing such music in securitization deals. More generally, the process of securitization of music royalties is hampered because it depends upon predictions about the long-term value of different forms of music.

¹⁴³ See Serwer, *supra* note 8, at 313.

¹⁴⁴ See Chip Cummins & Cecile Gutscher, *Head-Banging Bonds: Can Ozzy Osborne Make Investors Bite?*, WALL ST. J., July 26, 1998, at C26.

¹⁴⁵ See *Ain't Too Proud*, *supra* note 127, at 119. The deal was likewise undesirable because it involved copyright disputes.

¹⁴⁶ See Johnnie L. Roberts, *The Rap on Rap*, NEWSWEEK, Feb. 22, 1999.

¹⁴⁷ *Id.* For example, such skepticism continues despite the fact that sales for Def Jam records, a recording company featuring many rap artists, almost tripled in 1998.

D. Intellectual Property Concerns Associated with Royalty-Based Securitizations

David Pullman has indicated that copyright-related concerns represent the biggest impediment to royalty-based securitizations and "nine times out of ten" such concerns prevent the completion of these transactions.¹⁴⁸ The copyright issues that attorneys must evaluate to determine the viability of a securitization fall into two general categories: those dealing with ownership and those associated with perfecting a security interest in a copyright and its related royalties. Both issues impact the value and viability of using copyrights and their royalties in a securitization.

1. Issues Related to Copyright Ownership

Establishing ownership of a copyright represents a critical component to the success of a securitization because it allows one to assess the value of a copyright while protecting copyright holders against third-party claims. At first blush, ownership of a copyright does not appear to be very important to these transactions because the transferor of royalty payments does not need to own the copyright on which the royalties are based.¹⁴⁹ Rather, a company or individual must establish its right to receive the money generated by the copyright in order to transfer that right.¹⁵⁰ Still, ownership of a copyright impacts several features of the securitization process.

(a) The Impact of Ownership on Certain Legal Safeguards

Identifying the owner of a copyright is important because only such an owner can take advantage of certain

¹⁴⁸ See *Ain't Too Proud*, *supra* note 127, at 119.

¹⁴⁹ See Bencivenga, *supra* note 126, at 5 (quoting an attorney at Willkie Farr & Gallagher, who participated in the David Bowie deal, as saying that "the important part [of a securitization] is determining where the royalties go").

¹⁵⁰ See *id.*

legal remedies that protect the value of the copyright. As one author asserted, "[d]etermining the ownership of [a] copyright is of fundamental importance in resolving nearly all copyright controversies."¹⁵¹ The Copyright Act of 1976¹⁵² entitles those who register their work with the United States Copyright Office to file an infringement suit and to recover statutory damages and attorneys' fees.¹⁵³ However, a copyright's ownership must be established in order to register a copyright with the Copyright Office.¹⁵⁴ Thus, a royalty-backed securitization is less desirable when ownership, a prerequisite for taking advantage of certain legal safeguards designed to protect the value of copyrights, is in dispute.

(b) The Importance of Ownership for Evaluating a Copyright

Identifying the copyright owner is also important for determining the value of a particular copyright. First, if a copyright is jointly owned, its value to a securitization may be diminished when both owners do not participate in the transaction. Indeed, each joint owner¹⁵⁵ of a copyright owns an undivided interest in the entire copyright, irrespective of

¹⁵¹ Charles D. Ossola, *Recent Developments Relating to Copyright Ownership and Transfer*, 481 PLI/PAT 7, 9 (1997).

¹⁵² 17 U.S.C. §§ 101-1010 (1994).

¹⁵³ See *id.* §§ 411(a), 412.

¹⁵⁴ See *id.* § 409

¹⁵⁵ See, e.g., Ossola, *supra* note 151, at 40. Jane G. Stevens et al., *Joint Ownership Under the Copyright Act: Yours, Mine or Ours? A Survey of the Law*, C962 ALI-ABA 119, 142 (1994). Each joint owner, without the consent or knowledge of the other owner, can exercise all rights in the copyright, subject only to the duty to account to the other for profits. See, e.g., *Oddo v. Ries*, 743 F.2d 630, 633 (9th Cir. 1984); *Sweet Music, Inc. v. Melrose Music Corp.*, 189 F. Supp. 655 (S.D. Cal. 1960). State law governs controversies relating to royalty payments between joint owners. Indeed, the House Report accompanying the Copyright Act explained that joint owners are treated as tenants in common with respect to their copyright interests, see H.R. Rep. No. 1476, 94th Cong., at 121 (1976). Thus state law relating to co-owners, not the Copyright Act, governs their claims for an accounting of profits. See *Oddo*, 743 F.2d at 633.

their contribution. Because of this arrangement, in the absence of an agreement, all joint owners share equally in the royalty payments.¹⁵⁶ Yet, any one joint owner can transfer only its portion of the royalty payment generated from a song in a securitized transaction. Thus, a jointly-owned song may be less valuable for securitization if only one owner is involved in the deal because the amount of royalties that can be generated to pay dividends will be reduced. In fact, Michael Jackson's deal was halted because Song Corp., which jointly owns the rights to Michael Jackson's songs, was unwilling to participate in their securitization.¹⁵⁷ Thus, "the big challenge for entertainment securitization is that Mr. Jackson's situation [of co-ownership] is typical of entertainers."¹⁵⁸

Second, if an artist's copyright is limited to certain components of a song, the royalties he receives from such a copyright is also limited. Consequently, the copyright's value to the securitization process is reduced. In fact, most songs include at least two copyrights. The artists who write the lyrics to a song hold a copyright in the musical composition, while the artists who perform and record the song hold a sound recording copyright.¹⁵⁹ A copyright in the composition includes the right to reproduce, distribute and publicly perform the composition.¹⁶⁰ Hence, royalties stem from all such reproductions and distributions. By contrast, the right to the sound recording only encompasses the right to reproduce and distribute a particular artist's recording.¹⁶¹ In fact, not only must the holders of the sound recording copy-

¹⁵⁶ See Stevens, *supra* note 155, at 142. Moreover, upon their death, the heirs and legatees of the joint owner acquire his or her share. See *id.*

¹⁵⁷ See Duran, *supra* note 119.

¹⁵⁸ *Id.*

¹⁵⁹ See A. Dustin Mets, Note, *Did Congress Protect the Recording Industry Into Competition? The Irony of the Digital Performance Right in Sound Recordings Act*, 22 U. DAYTON L. REV. 371, 373 (1997).

¹⁶⁰ See 17 U.S.C. §§ 106(1) & (3), 115.

¹⁶¹ See *id.* § 114(a).

right receive permission from the holders of the composition copyright to make their recording,¹⁶² but they must also share their royalties with the holders of the composition right as part of that license. Then too, because the sound recording copyright does not include a performance right, the holders of a sound recording copyright only receive royalties when someone purchases or permanently delivers the physical product containing the sound recording.¹⁶³ Thus, the sound recording copyright may have less value than the composition copyright. Because artists who hold particular copyrights are entitled to different royalty payments, determining who holds what rights is an important aspect of the securitization process. Indeed, the process could result in investors restricting securitization to those who hold particular copyrights.

For example, a restriction is a concern for musicians who own copyrights in songs that utilize "sampling." Sampling is the practice of using an existing song or sound recording in new music.¹⁶⁴ This practice limits the value of a copyright because the author of the new music must share her royalties with the holder of the sound recording copyright as well as the holder of the composition copyright. David Pullman has confirmed that because hip-hop music is dominated by artists who use sampling,¹⁶⁵ such music may

¹⁶² See *id.* §§ 115(a) & (c).

¹⁶³ See *Mets*, *supra* note 159, at 374-75. Congress has sought to protect copyright holders from new technologies that could replicate the physical product and hence reduce sales related to it. See *id.* In 1995, Congress passed the Digital Performance Right in Sound Recordings Act which was designed to prevent the delivery of sound recordings through the Internet without a payment of royalties. See *id.* at 375-81. That Act set up a royalty collection structure and required payments based on a delivery of a sound recording through the Internet without a physical container. See *id.* at 379-81.

¹⁶⁴ See, e.g., Robert M. Szymanski, *Audio Pastiche: Digital Sampling, Intermediate Copying, Fair Use*, 3 UCLA ENT. L. REV. 271, 277-79 (1996); Nels Jacobson, Note, *Faith, Hope & Parody: Campbell v. Acuff-Rose, 'Oh, Pretty Woman,' and Parodists Rights*, 31 HOUS. L. REV. 955, 970-71 (1994).

¹⁶⁵ See, e.g., Michael L. Baroni, *A Pirate's Palette: The Dilemmas of Digital Sound Sampling and A Proposed Compulsory License Solution*,

not serve as a profitable subject of securitization.¹⁶⁶ By contrast, the fact that James Brown's music is often sampled makes it a profitable source of securitization because such sampling generates revenue for Mr. Brown.¹⁶⁷

(c) The Impact of Copyright Controversies Related to Ownership

Because copyrights are the subject of ownership and infringement disputes, music and songs' ability to be securitized may be jeopardized. For example, the music unit of EMI Music recently filed suit in New York to block the sale of the Isley Brothers copyright to the Pullman Group. In its defense, the Pullman Group has claimed that the suit is designed to interfere with its plans for securitization. Whatever its motivation, the suit may have the effect of precluding the sale of securities backed by the future royalty stream of the Isley Brothers music.¹⁶⁸

Moreover, prior to the Motown securitization, Eddie Holland had been engaged in a battle for more than seven years with his music publisher regarding the royalties generated by some of the songs used in his securitization.¹⁶⁹ Holland claimed that his publisher forged the songwriting contracts that transferred his copyrights.¹⁷⁰ Although he agreed on a royalty arrangement for the songs, Holland and his writing partners have since filed several new suits

11 U. MIAMI ENT. & SPORTS L. REV. 65, 70-71 (1996) (noting that sampling is central to rap and hip-hop music); see also Jacobson, *supra* note 164, at 967 (noting that sampling is an integral component of modern hip-hop culture).

¹⁶⁶ See Roberts, *supra* note 118.

¹⁶⁷ See Roper, *supra* note 99 (discussing the fact that new artists continue to sample works by James Brown).

¹⁶⁸ See Irv Lichtman, *April Challenges Pullman/Isley Deal*, BILLBOARD, Oct. 2, 1999, at 7.

¹⁶⁹ See Don E. Tomlinson, *Everything that Glitters is Not Gold: Songwriter-Music Publisher Agreements and Disagreements*, 18 HASTINGS COMM/ENT. L.J. 85, 136-37 (1995) (explaining Holland's dispute related to royalties on songs such as "Stop! In the Name of Love").

¹⁷⁰ See *id.* at 137.

seeking royalties and the return of their copyrights from the music publisher.¹⁷¹ While this litigation did not prevent the Motown songwriters from completing their deal, the diligence related to it increased deal costs and created concerns about its ultimate viability. Moreover, similar forms of copyright litigation prevented investors from taking advantage of a proposed deal with Death Row Records ("Death Row") involving songs by Tupac Shakur.¹⁷² Indeed, Shakur's mother, together with two other rap artists, sued Death Row claiming that the company did not own the copyrights to Shakur's music and owed millions of dollars to Shakur's estate.¹⁷³ Though ultimately settled out of court,¹⁷⁴ the suit made a securitization involving Shakur's music unattractive to most investors. These suits demonstrate how legal challenges to ownership of copyrights precludes securitizing the royalties related to them.

Such suits particularly threaten the securitization of rap, hip-hop and sampled due to the increased likelihood that such music will be challenged for copyright infringement.¹⁷⁵ Consequently, since much of hip-hop and rap music is dominated by sampling,¹⁷⁶ there is a greater risk that these genres of music may be the subject of infringement suits. Indeed, one of the most well known copyright infringement suits, *Campbell v. Acuff-Rose Music, Inc.*, involved a challenge to a rap artist's sampling of a copyrighted song.¹⁷⁷ Although the Supreme Court ultimately

¹⁷¹ See *id.*

¹⁷² See *Shakur's Mom Sues Death Row for \$17M, Missing Records, L. A. SENTINEL*, May 7, 1994, at A4. See also *Borrowers*, *supra* note 8, at 114.

¹⁷³ See *Shakur's Mom Sues*, *supra* note 172, at A4.

¹⁷⁴ See *id.*

¹⁷⁵ See, e.g., Alan Korn, Comment, *Renaming That Tune: Aural Collage, Parody and Fair Use*, 22 GOLDEN GATE U. L. REV. 321, 334 (1992) (noting that concerns over copyright infringement have grown with the increase in sampling).

¹⁷⁶ See Baroni, *supra* note 165.

¹⁷⁷ See *Campbell v. Acuff-Rose Music, Inc.*, 510 U.S. 569 (1994). In *Campbell*, 2 Live Crew, who sampled portions of the song "Oh, Pretty Woman" in order to create a parody, was sued for copyright infringement.

determined that the rappers' sampling constituted fair use under the Copyright Act, the more than three-year long case revealed that such music is uniquely vulnerable to copyright challenges. Because of this vulnerability, artists who produce hip-hop and rap music may find it difficult to take advantage of securitization.

2. Uncertainties Relating to the Perfection of a Security Interest in a Securitized Asset

In order for a securitization to be viable, attorneys must establish that investors can perfect their interest in royalty payments and, if the securities are bonds, in the copyright itself.¹⁷⁸ A security interest permits security holders to repossess the copyright and related receivables if their bonds default. Also, once a bond defaults, the party holding the security interest must be able to enforce her rights against the claims of other creditors. When there are such competing claims, the party who has perfected its claim has priority and can subordinate the claims of others.¹⁷⁹ Hence, attorneys must be able to show that the security interest granted to bondholders pursuant to royalty-backed securitizations can be perfected and is not subordinated.

However, as one attorney who worked on the David Bowie deal observed, "[i]t's a challenge to try and figure out how to perfect a security in this vehicle."¹⁸⁰ Until recently,

¹⁷⁸ Because all of the royalty-based securitizations to date have been structured as bond offerings and the perfection concerns related to equity securities are subsumed in those related to debt obligations, this Article will discuss the perfection issues in the context of royalty-backed securities that take the form of bonds.

¹⁷⁹ See, e.g., Jeffrey R. Capwell, *Secured Financing in Intellectual Property: Perfection of Security Interests in Copyrights to Computer Programs*, 39 SYRACUSE L. REV. 1041, 1056 (1988).

¹⁸⁰ Copulsky, *supra* note 84 (quoting a partner from Willkie Farr & Gallagher who advised Pullman on the David Bowie deal); see also Bencivenga, *supra* note 126, at 5 (quoting another Willkie Farr attorney as noting that "it's not always clear where you go about perfecting the interest" transferred in a securitization).

no case law specifically addressed the method for perfecting a security interest in a copyright.¹⁸¹ In 1990, a California federal district court became the first to confront the issue in *In re Peregrine Entertainment, Ltd.*¹⁸² In *Peregrine*, the court held that a security interest in a copyright and the receivables generated therefrom could only be perfected by a filing with the Copyright Office.¹⁸³ Other courts afforded this decision great weight because its author was a United States Circuit Judge sitting by designation.¹⁸⁴ Subsequently, in *Broadcast Music Inc. v. Hirsch*, the U.S. Court of Appeals for the Ninth Circuit held that an assignment of future royalties arising from copyrighted music was not a security interest and thus, could be perfected without a prior filing with the Copyright Office.¹⁸⁵ Because royalty-based securitizations have involved the assignment of royalty payments as well as the creation of a security interest in the copyright connected with those payments, these two cases create confusion for those seeking to engage in such transactions.

Peregrine requires those seeking to perfect a security interest in a copyright and its receivables to file the interest with the Copyright Office and penalizes those who do not file by rejecting their claim to any assets. In *Peregrine*, the predecessor of the debtor had been issued a six million-dollar line of credit secured by a library of films and its related accounts receivable.¹⁸⁶ The issuing bank filed UCC-1 financing statements pursuant to state law to evi-

¹⁸¹ See Capwell, *supra* note 179, at 1070-71 (describing the lack of decisions that resolve the issue of how a security interest in a copyright is properly perfected). Most other security interests are perfected through the filing of a financing statement pursuant to the Uniform Commercial Code (the "UCC") as enacted in the relevant state. See *id.* at 1058.

¹⁸² See *In re Peregrine Entertainment, Ltd.*, 116 B.R. 194 (C.D. Cal. 1990).

¹⁸³ See *id.*

¹⁸⁴ See David Gould et al., *Bankruptcy's Impact on Copyright: Selected Problems*, 529 PLI/PAT 163, 181 (1998). Judge Alex Kozinski of the U.S. Court of Appeals for the Ninth Circuit authored the opinion.

¹⁸⁵ 104 F.3d 1163 (9th Cir. 1997).

¹⁸⁶ See *Peregrine*, 116 B.R. at 197.

dence its security interests.¹⁸⁷ Four years later, the debtor, who apparently had no knowledge of the security agreement between its predecessor and the bank,¹⁸⁸ filed a voluntary bankruptcy petition. Under applicable bankruptcy law, upon the filing of such a petition, the debtor obtained a judicial lien on the copyrights and their receivables.¹⁸⁹ That lien took priority over unperfected security interests.¹⁹⁰ Once aware of the bank's claim, the debtor filed an amended petition contending that the bank's security interests were unperfected because they had not been filed with the Copyright Office.¹⁹¹ The bankruptcy court disagreed and held that such a filing was not necessary for the bank's claim to be perfected. The district court reversed, concluding that because the bank had not filed its interest with the Copyright Office the bank's claim had not been perfected. Since the debtor's judicial lien took priority over the bank's unperfected security interests,¹⁹² the district court's conclusion served to extinguish the bank's claim to the copyrights and their royalty-related receivables.

The district court reached its conclusion by reasoning that the Copyright Act provided for the recording of a security interest in a copyright as well as the receivables generated therefrom. The Act permits, but does not require, "[a]ny transfer of copyright ownership or other document pertaining to a copyright" to be recorded in the Copyright Office.¹⁹³ The Act defines the term "transfer" to include the terms mortgage and hypothecation, which in turn covers a pledge of property as a security.¹⁹⁴ According to the *Peregrine* court, these definitions made it "clear" that the Act allowed security interests in copyrights to be recorded at the Copyright Office.¹⁹⁵ The court then explained that be-

¹⁸⁷ See *id.*

¹⁸⁸ See *id.* at 207.

¹⁸⁹ See *id.* at 205.

¹⁹⁰ See *id.*

¹⁹¹ See *id.* at 198.

¹⁹² See *id.* at 207-08.

¹⁹³ 17 U.S.C. § 205(a).

¹⁹⁴ See *id.* § 101.

¹⁹⁵ See *Peregrine*, 116 B.R. at 199.

cause a copyright entitles its holder to receive all income derived from the copyrighted work, the security interest in the receivables from a copyright may also be recorded.¹⁹⁶

After determining that such interests could be recorded with the Copyright Office, the court focused on whether perfection could be achieved by another means. On this point, the court noted that state and federal law contained conflicting priority schemes.¹⁹⁷ Because of this, the court concluded that, although the Copyright Act's recording provisions were voluntary, the interest in creating a uniform priority scheme, coupled with the comprehensive nature of the Copyright Act, meant that federal law preempted the state's UCC filing methods for perfecting these security interests.¹⁹⁸

By contrast, in *Broadcast Music, Inc. v. Hirsch*, the Ninth Circuit recently upheld a security interest in future royalty payments that was not recorded with the Copyright Office. In that case, a songwriter assigned his future royalty payments to Broadcast Music, Inc. ("BMI") to satisfy certain debts he owed. Although the document evidencing the assignment purported to grant a security interest in the payments, it was not recorded with the Copyright Office. After the assignment, the Internal Revenue Service assessed a tax lien against the songwriter's royalty income.¹⁹⁹ Pursuant to federal law, the tax lien was perfected upon assessment.²⁰⁰ The Ninth Circuit found that the assignments did not involve a transfer of an ownership interest within the meaning of the Copyright Act. Because federal law did not apply, the court analyzed the issue under state contract law and concluded that the unrecorded assignments took precedence over the tax lien. Thus, the Ninth Circuit allowed a prior transfer of royalties to prevail

¹⁹⁶ See *id.*

¹⁹⁷ See *id.* at 201. The Copyright Act provides that a transfer executed first prevails if it is recorded before the conflicting transfer or within one month of execution. See 17 U.S.C. § 205(d). By contrast, under the UCC, the security interest perfected first generally prevails.

¹⁹⁸ See *Peregrine*, 116 B.R. at 194.

¹⁹⁹ See *Broadcast Music*, 104 F.3d at 1165-66.

²⁰⁰ See *id.*

against a perfected interest despite the failure to record such transfer.

The Ninth Circuit distinguished *Peregrine* by explaining that while, *Peregrine* involved a security interest in a copyright and related royalties, *Broadcast Music* was "a case of outright assignments of a right to receive royalties for the purpose of satisfying a debt."²⁰¹ This explanation failed to pinpoint adequately the difference between the assignment of royalty payments in *Broadcast Music* and the transfer of royalty-related receivables in *Peregrine*. Despite the Ninth Circuit's characterization of the *Broadcast Music* transfer as an "assignment," in both cases the agreement transferring the royalty payments purported to create a security interest.²⁰² As one author noted, the Ninth Circuit's "purported distinction of *Peregrine* does not appear very impressive (or sincere)."²⁰³

Since royalty-based transactions have included both the transfer of future royalty payments and the establishment of a security interest in the copyrights and their related payments, these two cases create a dilemma for those structuring such transactions. Parties to a securitization clearly intend to create a security interest in the copyright and establish a priority in the bondholders' right to receive the royalty-related receivables. Because of this intent, *Peregrine* suggests that these transactions must include a filing with the Copyright Office. In fact, the transaction included a filing with the Copyright Office and under the UCC.²⁰⁴

²⁰¹ *Id.* at 1166.

²⁰² *See id.* at 1166-67.

²⁰³ G. Larry Engel, *Intellectual Property and Related Asset Considerations in Bankruptcy Cases: Recent Developments Illustrate a Future Trend of Dysfunctional Conflicts Among Competing IP and Commercial Laws in Need of Reconciliation for Good Business*, 767 PLI/COMM 1009, 1022 (1998); *see also* Ossola, *supra* note 151, at 63-64 (describing the *Peregrine* decision as "misguided" and noting that it has created "much consternation among business attorneys").

²⁰⁴ *See* Jennifer Burke Sylva, *Bowie Bonds Sold for Far More Than a Song: The Securitization of Intellectual Property as a Super-Charged Vehicle for High Technology Financing*, 15 SANTA CLARA COMPUTER & HIGH TECH. L.J. 195, 223 (1999).

Unfortunately, even this dual filing may not protect investors against courts that follow *Broadcast Music* and determine that an earlier unrecorded transfer takes precedence over the bondholders' security interest. Indeed, while some courts have followed *Peregrine* even after *Broadcast Music*,²⁰⁵ others, such as the New York Supreme Court, have criticized *Peregrine* for including accounts receivable as an asset that is capable of being recorded at the Copyright Office.²⁰⁶ Moreover, many in the intellectual property industry have lobbied Congress to reverse *Peregrine* as it applies to receivables related to copyrights²⁰⁷ and some analysts have noted that "secured creditors are still prepared to litigate an appropriate case to challenge the *Peregrine* . . . decision."²⁰⁸ Thus, at least with respect to copyright related receivables, the manner for perfecting a security interest is unclear and is the subject of controversy. This uncertainty creates risk for investors that could undermine the widespread growth of royalty-backed securitizations.

This risk is compounded by the uncertainty inherent in the copyright law itself. Any composition authored before Congress implemented the Copyright Act of 1976 is governed by the Copyright act of 1909.²⁰⁹ That Act enables compositions authored prior to 1976 to be renewed by the heirs of an author. Thus, if an author dies, his heirs would have a claim to the copyrights, impairing the security interest of the bondholders. Such a problem daunted Mr. Bowie,

²⁰⁵ See, e.g., *In re Avalon Software, Inc.*, 209 B.R. 517 (Bankr. D. Ariz. 1997) (holding that a security interest in a software copyright and its related receivables must be perfected by a filing with the Copyright Office).

²⁰⁶ See *MCEG Sterling, Inc. v. Phillips Nizer Benjamin Krim & Ballon*, 646 N.Y.S.2d 778, 780 (N.Y.Sup.Ct. 1996).

²⁰⁷ See, e.g., Engel, *supra* note 203, at 1021-22 (pointing out efforts of those in Congress and members of the ABA Task Force of Security Interest in Intellectual Property).

²⁰⁸ Engel, *supra* note 203, at 1017.

²⁰⁹ See 17 U.S.C. § 24 (1994).

who resolved any uncertainties on the title to his copyrights with a release from his heirs.²¹⁰

E. Creating a Portfolio to Overcome Some of the Obstacles to Royalty-Based Securitization

1. Benefits of Royalty-Based Portfolios

While it may require a clarification in the law to reduce the copyright concerns related to securities backed by royalties, some other problems may be overcome by creating a portfolio of loans to be pooled in the future as royalty-backed securities. First, by relying on royalties from many different artists, pooling such royalties diversifies the risk that a particular artist's popularity may decrease and affect future royalty payments negatively. Pooling assets "takes away the risk of investing in single names."²¹¹ Second, pooling revenues from different entertainers enables record companies to participate more fully in these securitizations. Such companies may hold a variety of different copyrights that can be used for securitizations.

Moreover, pooling royalties into a portfolio may contribute to the success of royalty-backed securities by making them available to the public. Currently, only wealthy investors such as large companies, insurance funds, or pensions funds have the resources to purchase securities backed by royalties. However, an individual may be able to afford such securities if they are pooled and offered through special mutual funds. Structuring this type of fund may be a critical source of growth for royalty-backed securities because, while institutional investors may be more risk-averse, many "people will buy [these] bonds just because of the [star's name associated with it], even if they know nothing about the underlying economics."²¹² Thus,

²¹⁰ See Sylva, *supra* note 204, at 224.

²¹¹ Borrowers, *supra* note 8, at 107.

²¹² Copulsky, *supra* note 84 (quoting Donald Smart, senior vice president of the investment firm that has reportedly discussed

creating a pool of royalty-backed securities could eliminate some hurdles to their consummation and enhance their growth by making them available to the general public.

2. Challenges to Creating Successful Portfolios

One stumbling block to offering a pool of royalty-related bonds is that companies who issue such an offering must have enough resources to warehouse a significant value of loans and to research the copyright issues associated with each loan. Insiders estimate that the critical or highest dollar value for a pool of royalty-backed securities is about \$100 million.²¹³ If this is true, only companies willing to spend such a large amount of money will be able to participate in the pooling process. Indeed, Prudential Securities reportedly is prepared to invest \$200 million to assist Mr. Koppelman's plans to warehouse loans for securitization.²¹⁴ In order to ensure that the royalty-backed security is viable, companies must utilize time and resources to research the copyright issues associated with each royalty stream. This procedure can be both expensive and time consuming, and may explain why companies began the pooling process more than a year ago,²¹⁵ but to date no such issuances have come to market.

In addition to the resources required to generate a viable pool of royalty-related receivables, architects of these receivables will also need two key ingredients similar to any asset bond offering that attempts to mitigate the risk associated with its underlying assets: diversity and

transactions regarding securitizing royalties from Michael Jackson and Bob Marley).

²¹³ See Lisa Tibbitts, *Prudential Securities Preps Royalty-Backed Bonds*, PRIVATE PLACEMENT LETTER, Feb. 9, 1998 (explaining that the "critical mass" for a single artist is about \$25 million, while critical mass for a pool of artists is \$100 million).

²¹⁴ See Newcomb, *supra* note 8, at 43.

²¹⁵ See *Hit Parade*, *supra* note 97, at 108 (discussing Pullman's plans to package loans in March of 1998); *Borrowers*, *supra* note 8 (discussing Mr. Koppelman's plans to package loans).

over-collateralization.²¹⁶ As explained earlier, diversification is important because it reduces the problems, such as diminishing popularity, related to investing in one artist. For securities backed by music royalties, a diverse pool is one in which the music and artists associated therewith appeal to a diverse audience and can be exposed to various media, including commercials and sampling. In essence, these pools must replicate the diversity of those artists who have been able to complete a securitization successfully, capturing fans both domestically and internationally.²¹⁷ Additionally, these pools probably should not be limited to one genre of music because a rap bond may have less appeal than one featuring both rock and rap entertainers.²¹⁸ If companies achieve diversification with their pool of royalties, their offerings will receive higher ratings and thus, be more successful.

Another technique that these pools will need to utilize is that of over-collateralization. If a securitization is over-collateralized, it will instill confidence in investors. Although there is no exact formula for determining the proper level of over-collateralization, consultation with rating agencies and entertainment experts can help insure that each pooled issuance obtains the level necessary to receive a high credit rating. Since some insiders estimate the annual royalty stream for songwriters and composers to be in excess of \$800 million and the potential market to be over \$15 billion,²¹⁹ there is great potential for creating pools of music related royalties, even with a high degree of over-collateralization.

²¹⁶ See Alfred J. Puchala, Jr., *Securitizing Third World Debt*, 1989 COLUM. BUS. L. REV. 137, 144, 162 (pinpointing the importance of these two factors in securitization for third world countries).

²¹⁷ See Duran, *supra* note 119 (explaining that Mr. Bowie's offering was a success because of his large fan base).

²¹⁸ In the third world context where investors share similar hesitations regarding the reliability of the assets underlying their bonds, one author has noted that securitization of that debt should not focus on only one country. See Puchala, *supra* note 216, at 162.

²¹⁹ See James K. Perkins, *Can Securitization Clear Barriers to Hollywood?*, ASSET SALES REP., April 27, 1998, at 1.

Recognizing that the market for royalty-based securities can be expanded greatly through mutual fund-styled securities, many companies already have begun the pooling process. Indeed, the Pullman Group is structuring a pooling transaction with a group of entertainers featuring Bob Dylan.²²⁰ Koppelman has announced similar plans to create a pool of royalty-backed issuances by August of 1999.²²¹ Each of these groups hopes that such pooling arrangements will overcome investor concerns and enable them to duplicate the success of David Bowie's bonds.

IV. CONCLUSION

Predictions that royalty-based securitizations would become a significant source of financing for the music industry have failed adequately to account for the difficulties of securitizing royalties related to music. Given the advantages of securitization as well as the profit-generating capability of many artists, securitization of music royalties appeared to be a natural and profitable extension of the asset-backed securities market. Despite these advantages, the process of securitizing music royalties has been hampered by issues unique to the entertainment industry. The entertainment industry, however, can minimize each of these problems so that royalty-based securitizations may be consummated. First, the pooling process may serve to allay some investors' fears while increasing the number of artists who may participate in the securitization process. Second, while the various ownership and copyright issues will continue to hamper the securitization process, as entertainers come to understand the importance of clearly defined ownership rights to that process, the entertainers themselves may learn to better protect their ownership interests. This would enable artists to capitalize on the important source of funding that royalty-based securitization represents, as

²²⁰ See David Feldheim, *Pullman Seen Belting One for Elton John*, PRIVATE PLACEMENT LETTER, July 5, 1999.

²²¹ See *id.*

well as provide a viable investment to the public. Unfortunately, before a market for royalty-based securitizations can develop fully, investors and entertainers will need to overcome or mitigate the problems that have thus far sharply limited the growth of that form of financing. Until then, issuances of royalty-related securities will continue to be a "one-of-a-kind, difficult birth."²²²

²²² Copulsky, *supra* note 84.